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BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

PUBLIC UTILITIES
COMMISSION

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In the Matter of the Application)
)
HAWAIIAN ELECTRIC COMPANY, INC.)
)
For Approval of Rate Increases and)
Revised Rate Schedules and Rules)
_____)

Docket No. 2006-0386

DEPARTMENT OF DEFENSE'S
EXCEPTION TO AMENDED PROPOSED DECISION
AND ORDER 23768

October 31, 2007

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DoD's Exception to Amended Proposed Decision and Order 23768

DOD files this exception on the issue of interest synchronization to the Amended Proposed Decision and Order 23768 issued on 25 October 2007. DOD would like to commend the Chairman and the Commissioners for their efforts in finalizing this proceeding and issuing the Amended Proposed Decision and Order. .

This Commission has issued a series of orders wherein it has specifically addressed and not adopted the interest synchronization method. Indeed this Commission is one of the last holdouts and perhaps remains one of, if not the only state utility regulatory commission in the U.S. to **not** adopt interest synchronization.

The primary reason stated by the Commission in Amended Proposed D&O 23768 for not adopting interest synchronization is "the uncertainties" surrounding its use." Specifically, at page 21 of that Amended Proposed D&O, the Commission stated as follows:

"The commission is not persuaded in this instance that the simplicity of interest synchronization outweighs the **uncertainties** surrounding its use. As explained in Docket No. 6531:

"[T]he interest under the synchronization method is an imputed amount based on various components that make up the rate base. These components include both investor and noninvestor funds. **It is not clear what the effects might be of any significant changes in the components or their make-up over time. Since the interest is imputed, such changes may detrimentally affect the utility or its ratepayers.**"

(Emphasis supplied.)

There are a number of concerns presented by this logic. First, the **net** rate base amount – upon which the synchronized interest is calculated – is comprised **only** of investor-funded assets that are used and useful in providing utility service. This is done as part of the common regulatory practice of determining rate base, so investors earn a return only on the rate base that is funded by investors. Interest synchronization applies

the weighted cost of debt (i.e., the interest on debt that is recognized in the capital structure) to the net rate base that is funded by investors.

Second, the statement that “[i]t is not clear what the effects might be of any significant changes in the components or their make-up over time” is also somewhat troubling; because this statement would seem to apply with equal effect, or even more so, to HECO’s method of computing the interest deduction for calculating pro forma income tax expense for ratemaking purposes. HECO’s method is dependent upon such varying items as interest on long-term debt and hybrid securities and the estimated interest on short-term debt, as well as the pretax debt portion of allowance for funds used during construction (AFUDC). Any of these items can change from year-to-year. The amount of short-term debt and the pretax debt portion of AFUDC could change significantly from year-to-year. In summary, HECO’s method of calculating interest expense presents as much if not greater uncertainties as the interest synchronization method. Moreover, while it presents an equal or higher degree of uncertainty, HECO’s method fails to match or fully coordinate the components of the ratemaking formula with each other. Ultimately, HECO’s method is inferior to interest synchronization because it does not coordinate and match the capital structure, rate base and statement of net operating income.

Third and of vastly more importance to a fully informed and logically compelling decision on this issue, currently and realistically, is the fact that there is no longer any legitimate uncertainty over the propriety and fairness of interest synchronization as an appropriate utility ratemaking adjustment.

As explained in the DOD's filings, when the interest synchronization method of coordinating the weighted cost of debt in the utility's capital structure with the rate base and income tax calculation was originally proposed in utility rate cases in the 1980s, there were some legitimate uncertainties regarding the issues such as whether the imputation of interest to the portion of rate base funded by Job Development Investment Tax Credit ("JDITC," a form of investment tax credit) would cause a violation of the income tax normalization requirements of the Internal Revenue Code and Treasury Regulations. As the Code and Regs were not fully clear, there was a dispute regarding a utility's ability to use investment tax credits and/or accelerated tax depreciation. Therefore, some state utility regulatory commissions, including the Hawaii PUC, declined to adopt interest synchronization. However, all of the income tax issues were eventually resolved by a series of court decisions in favor of the interest synchronization method, and by statements from the Internal Revenue Service, indicating that it has accepted the interest synchronization procedure and will not challenge a utility's income taxes that are based on the proper use of interest synchronization for ratemaking purposes. In legitimately evaluating whether such "uncertainties," which existed in the 1980s, continue to exist today, DOD asks the Commission to carefully consider the cases cited and the related discussions presented by DOD in its briefs. DOD believes that a careful consideration by the Commission of the history of the interest synchronization issue will result in a conclusion that the 1980s "uncertainties" have ultimately been resolved overwhelmingly in favor of adopting interest synchronization as a legitimate and appropriate ratemaking method to assure proper coordination between the capital structure, rate base and statement of net operating income.

DOD submits that those decades old "uncertainties" perhaps now have tended to linger as the somewhat vague "uncertainties" concerning interest synchronization alluded to in this Commission's previous decisions, such as Decision and Order No. 11317 (filed on October 17, 1991, in Docket No. 6531) which was cited on page 21 of Amended Proposed D&O 23748.


In summary, the interest synchronization method is necessary in order to properly match and coordinate the components of the ratemaking process. The statement of utility net operating income is appropriately coordinated with the capital structure and rate base through the interest synchronization process, which multiplies the weighted cost of debt times the rate base to derive the interest deduction that is used in the pro forma income tax calculation.

DOD would like to re-emphasize that one of the primary features of interest synchronization is its fundamental fairness to both the utility and its ratepayers. The vast majority of state utility regulatory commissions in the U.S. have accepted the interest synchronization method as a fair and appropriate procedure that can be, and is, applied consistently in utility rate case after rate case. The utilities themselves include the interest synchronization in their filings when calculating pro forma income tax expense, and the other parties to the case, including the regulatory commission staff, consumer advocates and interveners all follow the same well-accepted interest synchronization methodology. Even the CA's accounting witnesses in the current HECO rate case from

Utilitech have strongly endorsed and routinely applied the interest synchronization procedure in the other jurisdictions in which they testify (except Hawaii).¹

DOD asks the Commission to realistically re-evaluate the "uncertainties" that are holding this Commission back from joining the vast majority of other U.S. state utility regulatory commissions, which have accepted interest synchronization as a fair and appropriate method of properly coordinating the elements of the ratemaking formula. The Commission should adopt interest synchronization as an official policy moving forward, for the fundamental reasons of proper matching and fairness. Otherwise, the Company's rate base, weighted cost of debt and income tax expense will not be properly matched. This will result in either an over- or an under-statement of the amount of income tax expense allowed for ratemaking purposes. Such a misstatement of income tax expense would be unfair to ratepayers (if it is overstated) or to HECO (if it is understated). Therefore, fairness and proper matching dictate the adoption of interest synchronization method in this case.

DATED: Honolulu, Hawaii, October 31, 2007


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¹ See, e.g., HECO's response to DOD-RIR-36 in Docket No. 04-0113, pages 155 and 156 of 446, wherein HECO provided an illustrative discussion of interest synchronization in a commission findings and order that referenced testimony by Mr. Carver, a witness for the CA in the HECO rate case.

CERTIFICATE OF SERVICE

I hereby certify that one copy of the foregoing DEPARTMENT OF DEFENSE EXCEPTION TO AMENDED PROPOSED DECISION AND ORDER 23768 was duly served upon the following parties, by personal service, hand-delivery, and/or U.S. mail, postage prepaid, and properly addressed pursuant to HAR sec. 6-61-21(d).

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